

PRINCIPLES AND PRACTICES FOR HEDGE FUND INVESTORS

HIGHLIGHTS OF RECOMMENDATIONS

Russell Read, Ph.D., C.F.A.
Chairman, PWG Investors' Committee
Chief Investment Officer, CalPERS

PWG Investors' Committee





PRINCIPLES AND PRACTICES FOR HEDGE FUND INVESTORS

- (1) What is the Concern about Hedge Funds?
- (2) The President's Working Group and Recently Created Committees
 - The Asset Managers' Committee
 - The Investors' Committee
- (3) Measures of Success for the Investors' Committee
- (4) Highlights of Report: Principles and Practices for Hedge Fund Investors
- (5) Looking Forward



The President's Working Group on Financial Markets

What is the Concern about Hedge Funds?

Long-Term Capital Management



Hedge fraud

A handful of scamsters, looking to exploit investors' fascination with the high returns of a hedge fund, raised about \$30 million by cold calling prospects — from this building at 39 Broadway — promising sky-high returns.

ANATOMY OF A SCAM

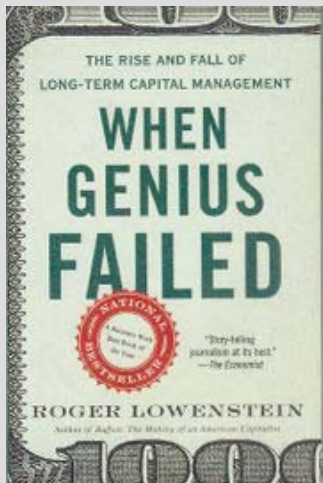
EARLY 2003	JUNE	MID 2005	SEPT. 2006	2007
A.R. Capital opened its doors downtown.	Began cold calling prospective clients touting its super-hot hedge fund.	Sent clients fraudulent statements touting a 100% return in six months.	A.R. Capital principals turned off office phones and vanished.	Sealed indictment handed up in Manhattan federal court; Securities and Exchange Commission and the FBI launch investigations.

Perhaps the saddest I have seen since the boiler room days of the 1980s and early 1990s.

If we ever run across them I don't know what we'd do. Fortunately, I don't carry a gun.

ROBERT BANKS
Bacon's lawyer

ED BACON was a \$700,000 victim of A.R. Capital



WANTED BY THE FBI
UNLAWFUL FLIGHT TO AVOID CONFINEMENT;
SECURITIES FRAUD

MICHAEL W. BERGER

Born: November 13, 1971
SSAN: 180-84-3097
Height: 5'8"
Weight: 180 pounds
Eyes: Blue
Hair: Blonde

MICHAEL WOLFGANG BERGER pleaded guilty to securities fraud charges in November of 2006 in connection with a scheme to defraud investors of more than \$300 million. Berger owned and operated a hedge fund called MANHATTAN INVESTMENT GROUP ("MIG"). Berger continues continuing to its 2002 and has no known to travel 2001 black BMW Airport on Oct 10

CNN/FILE



PRINCIPLES AND PRACTICES FOR HEDGE FUND INVESTORS

(2) The President's Working Group and Recently Created Committees

- (a) Purpose of PWG
- (b) PWG statements on hedge fund investments from 1999 and 2007
- (c) Sir Andrew Large's Hedge Fund Working Group
- (d) Asset Managers' Committee and Investors' Committee
- (e) Intended audience for each committee's report



Background of PWG

Executive Order 12631—Working Group on Financial Markets

Source: The provisions of Executive Order 12631 of Mar. 18, 1988, appear at 53 FR 9421, 3 CFR, 1988 Comp., p. 599, unless otherwise noted.

By virtue of the authority vested in me as President by the Constitution and laws of the United States of America, and in order to establish a Working Group on Financial Markets, it is hereby ordered as follows:

Section 1. *Establishment.* (a) There is hereby established a Working Group on Financial Markets (Working Group). The Working Group shall be composed of:

- (1) the Secretary of the Treasury, or his designee;
- (2) the Chairman of the Board of Governors of the Federal Reserve System, or his designee;
- (3) the Chairman of the Securities and Exchange Commission, or his designee; and
- (4) the Chairman of the Commodity Futures Trading Commission, or her designee.

(b) The Secretary of the Treasury, or his designee, shall be the Chairman of the Working Group.

Section 2. *Purposes and Functions.* (a) Recognizing the goals of enhancing the integrity, efficiency, orderliness, and competitiveness of our Nation's financial markets and maintaining investor confidence, the Working Group shall identify and consider:

- (1) the major issues raised by the numerous studies on the events in the financial markets surrounding October 19, 1987, and any of those recommendations that have the potential to achieve the goals noted above; and
- (2) the actions, including governmental actions under existing laws and regulations (such as policy coordination and contingency planning), that are appropriate to carry out these recommendations.

(b) The Working Group shall consult, as appropriate, with representatives of the various exchanges, clearinghouses, self-regulatory bodies, and with major market participants to



Background of PWG: 1999 Findings on Hedge Fund Regulation

Therefore, the Working Group recommends the following measures:

- More Frequent and meaningful information on hedge funds should be made public.
- Public companies, including financial institutions, should publicly disclose additional information about their material financial exposures to significantly leveraged institutions, including hedge funds.
- Financial institutions should enhance their practices for counterparty risk management.
- Regulators should encourage improvements in the risk-management systems of regulated entities.
- Regulators should promote the development of more risk-sensitive but prudent approaches to capital adequacy.
- Regulators need expanded risk assessment authority for the unregulated affiliates of broker-dealers and futures commission merchants.*
- The Congress should enact the provisions proposed by the President's Working Group to support financial contract netting.
- Regulators should consider stronger incentives to encourage offshore financial centers to comply with international standards.



Background of PWG: 2007 Findings on Hedge Fund Regulation

AGREEMENT AMONG PWG AND U.S. AGENCY PRINCIPLES ON PRINCIPLES AND GUIDELINES REGARDING PRIVATE POOLS OF CAPITAL

OVERARCHING PRINCIPLES

- 1. Private pools of capital bring significant benefits to the financial markets. However, these pools of capital also present challenges for market participants and policymakers. Investors, creditors, counterparties, pool managers, and supervisors must be aware of these challenges, including those related to some over-the-counter derivatives, and work to address them. Public policies that support market discipline, participant awareness of risk, and prudent risk management are the best means of protecting investors and limiting systemic risk.**
- 2. The vitality, stability and integrity of our capital markets are a shared responsibility between the private and public sectors. Market discipline most effectively addresses systemic risks posed by private pools of capital. Supervisors should use their existing authorities with respect to creditors, counterparties, investors, and fiduciaries to foster market discipline on private pools of capital. Investor protection concerns can be addressed most effectively through a combination of market and regulatory policies that limit direct investment in such pools to more sophisticated investors**



October 2007

Hedge Fund Standards: Consultation Paper PART 2: The best practice standards



Composition of PWG Committees

Asset Managers' Committee



Eric Mindich, CEO of Eton Park Capital Management

"...comprised of representatives from a broad array of asset managers. Its purpose is to facilitate an exchange of information between the alternative asset management community and the agencies comprising the...PWG."

Investors' Committee



Russell Read, CIO of CalPERS

"...comprised of representatives from a broad array of investors and investor advocates...from labor organizations, endowments, foundations, corporate and public pension funds, investment consultants, and other U.S. and non-U.S. investors."



The President's Working Group on Financial Markets

MEMBERS OF PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS

Russell Read, Chair, Chief Investment Officer,
California Public Employees' Retirement System (CalPERS)

Sandra Urie, Vice-Chair, Chief Executive Officer, Cambridge Associates, LLC

Gary Bruebaker, Chief Investment Officer, Washington State Investment Board

Myra Drucker, Chair of the Board of Trustees, Commonfund

Tom Dunn, Managing Principal, New Holland Capital

Peter Gilbert, Chief Investment Officer, Lehigh University Endowment Fund

Andrew Golden, President, Princeton University Investment Company

George Main, Chief Executive Officer, Diversified Global Asset Management Corporation

Salim Shariff, Chief Investment Officer, Weyerhaeuser Pension Fund

Ellen Shuman, Vice President and Chief Investment Officer, Carnegie Corporation of New York

Damon Silvers, Associate General Counsel, AFL-CIO

Greg Williamson, Chief Investment Officer, BP Pension Fund



Intended Audience of PWG Asset Managers' Committee

PRESIDENTS WORKING GROUP ON FINANCIAL MARKETS ASSET MANAGERS' COMMITTEE

Mission Statement

The Asset Managers' Committee is comprised of representatives from a broad array of asset managers. Its purpose is to facilitate an exchange of information between the alternative asset management community and the agencies comprising the President's Working Group on Financial Markets ("PWG"). It will be a standing committee, and its members serve at the behest of the committee's chairperson for three-year terms. Members may be reappointed for additional terms. It is expected that the committee will develop best practice guidelines, as described below, and also subsequently review and reassess, and if necessary revise, those guidelines.

The first task of the committee is to develop detailed guidelines that would define "best practices" for the alternative asset management industry, including practices regarding information, valuation, and risk management systems. They would foster efforts to enhance market discipline, mitigate systemic risk, augment regulatory safeguards regarding investor protection, and compliment regulatory efforts to enhance market integrity. These guidelines would review and build on existing industry work and the principles and guidelines released in February 2007 by the PWG, particularly Principle 9, where possible. The initial focus will be on practices for hedge fund managers.



Intended Audience of PWG Investors' Committee

PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS INVESTORS' COMMITTEE

Mission Statement

The Investors' Committee is comprised of representatives from a broad array of investors and investor advocates, potentially including representatives from labor organizations, endowments, foundations, corporate and public pension funds, investment consultants, and other U.S. and non-U.S. investors. Its purpose is to facilitate an exchange of information between the investor community and the agencies comprising the President's Working Group on Financial Markets ("PWG"). It will be a standing committee, and its members serve at the behest of the committee's chairperson for three-year terms. Members may be reappointed for additional terms. It is expected that the committee will develop best practice guidelines, as described below, and also subsequently review and reassess, and if necessary revise, those guidelines.

The first task of the committee is to develop detailed guidelines that would define "best practices" for investors in private pools of capital, including practices regarding information, due diligence, risk management, and reporting. They would foster efforts to enhance market discipline, mitigate systemic risk, augment regulatory safeguards regarding investor protection and compliment regulatory efforts to enhance market integrity. These guidelines would review and build on existing industry work and the principles and guidelines released in February 2007 by the PWG, particularly Principles 4, 5 and 8, where possible. The initial focus will be on practices related to investment in hedge funds.



PRINCIPLES AND PRACTICES FOR HEDGE FUND INVESTORS

- (3) Measures of Success for the Investors' Committee
 - (a) Best Practices
 - (b) Accepted Practices
 - (c) Common Practices
 - (d) Better informed and more successful use of hedge funds by investors



(4) Highlights of Investors' Committee Report: Principles and Practices for Hedge Fund Investors

Structure of the Report

1. Executive Summary
2. Introduction
3. Fiduciary's Guide
4. Investor's Guide

Principles and Practices for Hedge Fund Investors

President's Working Group on Financial Markets
Investors' Committee
Asset Managers' Committee



Investors' Committee Report--Highlights of the FIDUCIARY's Guide

Appropriateness of Hedge Fund Program

A. Hedge Fund Investments and Allocations

B. Hedge Fund Investment Policy

C. The Due Diligence Process

D. Conclusion



Investors' Committee Report--Highlights of the Fiduciary's Guide

Appropriateness of Hedge Fund Program

LOOK AT:

1. Temperament
2. Manager Selection
3. Portfolio Level Dynamics
4. Liquidity Match
5. Value Proposition
6. Citizenship



Investors' Committee Report--Highlights of the Fiduciary's Guide

A. Hedge Fund Investments and Allocations

1. Certain Characteristics of the Hedge Fund Industry
2. Fees
3. Considerations Prior to Investing in Hedge Funds
4. New Hedge Fund Programs and Managers
5. Roles in the Portfolio
6. Allocation and Diversification



Investors' Committee Report--Highlights of the Fiduciary's Guide

B. Hedge Fund Investment Policy

Develop explicit policies that address:

- What is strategic purpose of hedge funds in the portfolio?
- Is it consistent with beliefs, objectives and risk profile?
- What are the performance and risk objectives?
- Who is the manager and what are responsibilities?



Investors' Committee Report--Highlights of the Fiduciary's Guide

C. The Due Diligence Process

1. Legal, Tax and Accounting Considerations
2. Ongoing Monitoring



Investors' Committee Report--Highlights of the Fiduciary's Guide

D. Conclusion

- Improve risk/reward profile
- Satisfy investment objectives
- Expertise and resources to evaluate, retain, monitor, and terminate hedge fund managers



Investors' Committee Report--Highlights of the **INVESTOR'S** Guide

- A. The Due Diligence Process
- B. Risk Management
- C. Legal and Regulatory
- D. Valuation
- E. Fees and Expenses
- F. Reporting
- G. Taxation
- H. Conclusion



Investors' Committee Report--Highlights of the Investor's Guide

A. The Due Diligence Process

To assess whether a manager is an appropriate choice for portfolio:

1. Personnel
2. Business Management
3. Investment Performance Track Record
4. Style Integrity
5. Model Use



Investors' Committee Report--Highlights of the Investor's Guide

B. Risk Management

1. The Investor's Risk Management Programs
2. The Hedge Fund Manager's Risk Management Programs
3. Investment Risks
4. Liquidity and Leverage
5. Measurement of Market Risks and Controls
6. Management of Risk Limits
7. Compliance
8. Operational and Business Risks
9. Prime Broker and Other Counterparties
10. Fraud and Other Crimes
11. Information Technology and Business Recovery
12. Conflicts of Interest
13. Other Service Providers



Investors' Committee Report--Highlights of the Investor's Guide

C. Legal and Regulatory

1. Investment Structures
2. Domicile of Hedge Fund and Investments
3. Terms of Hedge Fund Investments
4. Fiduciary Duties (including ERISA)
5. Regulatory
6. Rights of Other Investors / Side Letters



Investors' Committee Report--Highlights of the Investor's Guide

D. Valuation

1. Valuation Policy
2. Governance of Valuation Process
3. Valuation Methodologies
4. Valuation Controls

E. Fees and Expenses

- Management Fees
- Performance Fees



Investors' Committee Report--Highlights of the Investor's Guide

F. Reporting

1. Reporting and Transparency
2. Performance Reporting
3. Fund of Funds Performance Measurement
4. Aggregate Portfolio Measurement

G. Taxation

1. Unrelated Business Taxable Income (UBTI)
2. U.S. and Foreign Tax Withholding
3. Changes to Capital Gain Allocations



Investors' Committee Report--Highlights of the Investor's Guide

H. Conclusion

The job of the investor is to understand the essential risk and reward prospects of each hedge fund investment and how these investments combine to meet the objectives of the hedge fund program in the overall portfolio. Investors should assess whether their managers' investment strategies are effective and are being executed consistently. Ultimately, investors must determine whether a manager's results are due to luck or skill, and therefore whether results are repeatable over time. This imperative requires that investors utilize quantitative as well as qualitative information and analysis. Effective reporting by managers will allow thoughtful investors to evaluate the manager's performance, strategy, organization and decision-making so that the investor may judge the suitability of each manager under consideration for inclusion in the investor's portfolio.



Investors' Committee Report--Highlights of the Investor's Guide

H. Conclusion

The job of the investor is to understand the essential risk and reward prospects of each hedge fund investment **essential risk and reward prospects** to meet the objectives of the hedge fund program in the overall portfolio. Investors should assess **executed consistently** investment strategies are effective and are being executed consistently. Ultimately, investors must determine whether a manager's results are due to luck **Effective reporting by managers** results are repeatable over time. This imperative requires that investors utilize quantitative as well as qualitative **evaluate performance** analysis. Effective reporting by managers will allow thoughtful investors to evaluate the manager's performance, strategy, organization and decision **for inclusion in the investor's portfolio** the suitability of each manager under consideration for inclusion in the investor's portfolio.



PRINCIPLES AND PRACTICES FOR HEDGE FUND INVESTORS

(5) LOOKING FORWARD

- (a) Both committees will be standing committees
 - will not dissolve after the publication of the reports
 - will continue to address areas of concern to the hedge fund industry and investors as they arise
 - will continue to address broader issues related to investment in private pools of capital
 - three year renewable terms among members
- (b) Intended to foster a healthy long-term environment for investors in private pools of capital and in the hedge fund industry

PRINCIPLES AND PRACTICES FOR HEDGE FUND INVESTORS

Russell Read, Ph.D., C.F.A.
Chairman, PWG Investors' Committee
Chief Investment Officer, CalPERS

PWG Investors' Committee

